BLOG POST
Brink of Destruction?
10/04/2021

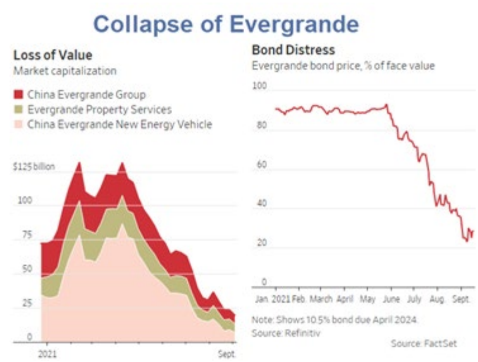
We live in a truly remarkable time.

Central Banks have progressed to the point where they not only are able to conquer the business cycle but eliminate the consequences of truly bad corporate behavior, regardless of the scale. The world was recently made aware of the pending bankruptcy of the largest property developer in China, Evergrande. Debts of the company exceed $300 billion, more than half of the size of Lehman that brought the global financial markets to a screeching halt in 2008, according to Bloomberg. According to Reuters, Evergrande also has $3.5 trillion of “unfinished” projects, which projects’ value equals 25% of the entire Chinese GDP.

When global markets became aware of how dire the situation was, they sold off as expected, for about 2 days. That’s right, the failure of the largest developer in what is soon to be the world’s largest economy, potentially pricking the global real estate and housing bubble, was thus far a 48 hour event. This is remarkable.

China’s real estate market has been described by many as a ‘house of cards.’ While Evergrande is the largest developer in China, it by no means is the only developer in trouble in Asia. The Chinese Communist Party and the People’s Bank of China have indicated they are not going to bail out Evergrande or other developers who are massively over-leveraged. Many suspect this is because Chairman Xi has a plan to nationalize the housing markets in China to reduce speculation and ultimately try to reduce the income divide. Without a Beijing bailout, there will be a fire sale on the assets of Evergrande, creating a domino effect of highly leveraged developers and the banks who financed them. Much of the more than $300 billion in debt is owed to parties outside of China, making it as likely to be contained as a coronavirus in a wet market.

The stock of Evergrande has fallen over 90% and their bonds are trading at $.30 on the $1 as this is being written. There likely will be unintended consequences of allowing Evergrande to collapse that will impact markets for more than 48 hours in the future. Few institutions are coming clear with their exposure today, but in time full disclosure will come.



Unlike Las Vegas, what happens in China does not stay in China. While most investors had not heard of Evergrande before last week, their problems have been years in the making and rapidly approaching the surface like the Old Faithful geyser in Yellowstone. There are signs of distress in the US economy that the stock market is largely ignoring at the time of writing.

The National Association of Business Economics (NABE) released a report recently that was shockingly bearish compared to data in May of this year. Just three months ago, only 15% of NABE economists believed risks were skewed to the downside. That number has risen to 58% believing we are in the early stages of an economic decline. The most worrisome aspect remains the global pandemic with two out of three respondents fearing a vaccine-resistant strain of Covid leading to an economic contraction, according to NABE. If the US recovery from Covid lockdowns stumbles in the next 12 months, the timing for China could be catastrophic.

The markets reacted to the Evergrande news with just short of a rapid 5% pullback, but immediately recovered and sit just 2% below the all-time highs of August. Market bulls are apparently Teflon-coated as they shake off the 10-year US Treasury bond yield back near 1.50% off the mini-correction lows of 1.20%. Not even the Fed announcing their plans to “taper” could derail the equity markets. The best gauge of market fear, VIX, managed to rise above 20 for 5 trading days before falling back into the range it has maintained most of the year.

Investor complacency appears to be at alarming levels given the risks that exist today. Confidence is waning, the Fed is at least spiking the punch bowl less, and the real estate bubble is at risk of bursting, yet it remains fashionable to remain long this market. They may be right. The markets survived an unprecedented lockdown of the economy, the closing of nearly 30% of all small businesses, and more than 30 million Americans losing their jobs, so why fear the liquidation of the world’s most indebted real estate developer?

History suggests now might be a good time to take some chips off the table and look for more attractive valuations for risk capital.